

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

THE SALE AND DETARIFFING OF)	ADMINISTRATIVE
EMBEDDED CUSTOMER PREMISES)	CASE NO. 269
EQUIPMENT)	

O R D E R

Procedural Background

On June 21, 1983, the Federal Communications Commission (FCC) released a Notice of Proposed Rulemaking in Docket No. 81-893, Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services, more commonly known as the Second Computer Inquiry or Computer II. This notice of proposed rulemaking was the result of an earlier Notice of Inquiry in this proceeding and was established to develop procedures under which all the embedded customer premises equipment (CPE) owned by the Bell Operating Companies (BOCs) would be detariffed and transferred to AT&T Information Systems, Inc. (ATTIS), formerly American Bell, Inc. In addition, procedures were proposed for the detariffing of embedded CPE held by the independent telephone companies. These procedures were to be developed so as to minimize administrative costs and protect subscribers.

In a related matter the Commission, in Administrative Case No. 257,¹ adopted the FCC's requirement that all new CPE be

¹ The Detariffing of Customer Premises Equipment Purchased Subsequent to January 1, 1983 (Second Computer Inquiry FCC Docket 20828).

detariffed effective January 1, 1983, and required each of the jurisdictional telephone utilities to submit allocation procedures necessary to maintain appropriate and separate accounts for new CPE.

On October 26, 1984, the FCC released its Third Report and Order in Docket No. 81-893. In the Third Report and Order, the FCC required state plans for detariffing embedded CPE to contain the following elements:

- (1) An implementation timetable
- (2) Valuation guidelines
- (3) State certification
- (4) Accounting and tax requirements
- (5) Other detariffing rules

In order to generate the information needed to develop a plan to detariff embedded CPE, the Commission initially solicited comments from all independent telephone companies in Kentucky through an Order dated September 21, 1983. After reviewing comments filed by the telephone companies and other parties, a second information request was issued on May 8, 1984. After these responses were received and reviewed, the Commission on October 4, 1984, issued a draft Order in this proceeding that permitted further comment on the options discussed in the draft Order. Comments were also solicited on the existence of unaccounted-for differences between CPE equipment per books and actual equipment in place or in inventory.

The first option proposed by the Commission in its draft Order would have allowed a telephone company to promote and sell,

under tariff, CPE to the subscriber in conjunction with recovery of CPE investment through regulated leasing. The second option would have allowed telephone companies to continue leasing to subscribers under present tariff and not engage in a sales program. Under both options, detariffing was proposed on December 31, 1987.

During October 1984 responses to the Commission's draft Order were received from 15 of the 20 independent telephone utilities. On May 1, 1985, General Telephone of Kentucky (GTKY) submitted additional comments. These comments, coupled with the issuance subsequent to the draft Order of the FCC's Third Report and Order, prompted the Commission to issue a further Order on June 4, 1985, setting a hearing to be held on June 27, 1985. This Order required GTKY to file testimony and invited all other parties to do the same.

On June 19, 1985, GTKY submitted a "generic plan" for the detariffing of embedded CPE. The generic plan was adopted by all jurisdictional independent telephone companies except Continental Telephone Company (Continental) and Cincinnati Bell Telephone Company (Cincinnati Bell).

The hearing was held on June 27, 1985, with the Attorney General's Consumer Protection Division intervening and participating. Briefs and reply briefs were filed by July 15 and July 25, 1985, respectively. All information requested has been filed.

Definition

For the purposes of this case, the Commission is defining embedded CPE as any equipment provided by a local exchange carrier and located on a customer's premises or in inventory, except overvoltage protection equipment, simple inside wiring, intrasystem wiring, coin-operated or other pay telephones, or multiplexing equipment used for the delivery of multiple channels to a customer, and which is recorded in accounts 231 or 234.

Valuation Method

The FCC in its Third Report and Order required the states to use economic value in the detariffing of embedded CPE and presented four alternatives for measuring or developing a surrogate for economic value:²

- (1) Imitating the process a firm would pursue in its capital budgeting process to estimate the economic value
- (2) Using net book value as a proxy for economic value
- (3) Relying on asset appraisal by independent appraisers
- (4) Conducting auctions

The generic plan offered by GTKY and other independent telephone companies proposed using the capital budgeting approach to determine economic value. In contrast, Continental and Cincinnati Bell favored using net book value as a proxy for economic value.

² Third Report and Order in CC 81-893, Released October 26, 1984, at 17 and 18.

When cross-examined as to why they were advocating the capital budgeting approach, the companies supporting the generic plan responded that first, they were of the opinion that net book value exceeded economic value, second, appraisals of the varied types of CPE would be too burdensome and costly, and, finally, an auction was not feasible.

The Commission was left with the task of deciding which of two approaches -- net book value or the capital budgeting process -- best met the criteria in the Third Report and Order for Kentucky. All parties to this proceeding agreed that either relying on independent asset appraisal or conducting auctions would be burdensome and inappropriate. After careful deliberation the Commission has concluded that net book value is the fairest measure of economic value for both investors and rate-payers.

The only evidence presented by generic plan companies to support the contention that net book value exceeds economic value was a capital budgeting study by GTKY of its embedded CPE. The Commission questions many of the assumptions used in the study, especially since GTKY failed to perform a sensitivity analysis. We view the results of the study as highly uncertain. Although by GTKY's own admission the study was preliminary, it does serve to demonstrate the problems inherent in the capital budgeting approach. In a capital budgeting study the sensitivity of the assumptions, such as cash flows and discount rates, can significantly affect the results. Though the generic plan called for

periodic true-ups based on revised capital budgeting studies, these problems would still be present.

The Commission is of the opinion that net book value coupled with the opportunity for companies to recover their investment in CPE prior to detariffing provides the fairest balancing of interests between ratepayers and investors as required by the FCC and the principles of Democratic Central Committee v. Washington Metropolitan Area Transit Commission, 485 F.2d 786 (D.C. Cir. 1973), hereinafter referred to as DCC. The evidence in this case indicates that net book value is a much more certain method of valuation than the capital budgeting process method. The FCC has found that net book value is a recognized valuation method and that it meets the DCC test.³ Indeed, the FCC has stated its intent to detariff embedded CPE of the Independent Telephone Companies at net book value in the event a state Commission fails to certify a plan.⁴

The thrust of the generic plan is to heavily favor the interests of investors, as supporters of the plan admitted during cross-examination.⁵ The Commission therefore finds that the Kentucky generic plan using a capital budgeting approach does not meet the balancing test required by the FCC. This same shortcoming characterizes the Continental plan, which advocates the simple amortization of net book value minus net salvage value

³ Id., at 3.

⁴ Id., at 24, and Order in CC 81-893 dated August 2, 1985.

⁵ Transcript of Evidence, June 27, 1985, page 91-93.

prior to detariffing. The Commission's plan more nearly resembles the approach recommended by Cincinnati Bell.

Although the Commission is convinced that net book value is the proper valuation method, we are sympathetic to some telephone companies' concern about the risk that net book value exceeds economic value. To mitigate these concerns, the Commission has considered this risk in setting authorized rates of return. For example, in Case No. 8859, GTKY's last general rate case, the Commission heard extensive testimony from GTKY's policy witness, Larry Sparrow, and its rate of return witness, John Dunn, that one basis for the rate of return requested by the company was the increased risk in its regulated CPE business.⁶ Dunn stressed that GTKY had a substantial investment in terminal equipment and there was uncertainty as to the recovery of that investment.⁷ "After having considered all of the evidence" in that case the Commission authorized a rate of return designed to compensate GTKY for all risks inherent in its business, including

⁶ Sparrow Prefiled Testimony, page 11, and Dunn Prefiled Testimony, pages 37-38.

⁷ Dunn Prefiled Testimony, pages 37-38.

terminal equipment.⁸ This approach conforms to the principles of DCC.⁹ It is also consistent with Kentucky case law.¹⁰

The Commission has carefully designed its plan to provide investors with the opportunity to achieve full capital recovery prior to detariffing, as required by the Third Report and Order.¹¹ In subsequent sections of this Order, we are providing flexibility in pricing and other marketing decisions for CPE. This will allow each telephone company the opportunity to recover the investment in CPE based on market conditions faced in its particular service territory.

The Commission has also considered the valuation of the supporting assets to be transferred, such as buildings and land. Under the appraisal method of valuation, any gain would accrue to the ratepayers. To be consistent, however, the Commission finds the book value of land and net book value of buildings to be the appropriate valuation method. Therefore, any gain will accrue to the investors. In this way, the Commission has further balanced the ratepayers' and investors' interest.

⁸ Order in Case No. 8859, January 4, 1984, page 30.

⁹ "[I]nvestors cannot recover for under-depreciated assets where they have in some form been compensated either for the deficiency or for assuming the risk that a deficiency might occur." DCC at 807.

¹⁰ City of Lexington v. Lexington Water Company, Ky., 458 S.W.2d 778 (1970), citing Board of Public Utility Commissioners v. New York Telephone Company, 271 U.S. 23, 70 L.ed. 808 (1926).

¹¹ Third Report and Order in CC 81-893, at 3, 16.

Implementation Timetable

The generic plan presented by the telephone companies requested an extension to December 31, 1990, beyond the FCC detariffing deadline of December 31, 1987. The FCC did allow such an extension on a case-by-case basis to assure full capital recovery.

The Commission is of the opinion that mandatory but flexible sales plans through December 31, 1987, will afford an opportunity for full capital recovery above the line. Therefore, the Commission will not request an extension to December 31, 1990.

The Commission will further allow any utility choosing to detariff between January 1, 1986, and December 31, 1987, to do so upon 30 days written notice.

Accounting and Tax Requirements

During the period prior to detariffing in which the telephone utility will be selling its embedded CPE, records are to be maintained as prescribed by the Uniform System of Accounts. As stated in the Third Report and Order, "existing accounting procedures reiterated for AT&T in the Order must be used by Independent telephone companies" for selling CPE under regulation.¹² The Report and Order released December 15, 1983, requires that a credit be made to the depreciation reserve for the proceeds realized on the sale.

This Commission, in following the accounting procedures established by the FCC, reiterates that a separate subsidiary for

¹² Id., at 20.

unregulated activities is not required. However, a separate set of books is to be maintained for unregulated activities. Thus upon detariffing of embedded CPE and supporting assets this Commission adopts the accounting procedures and joint allocation methodologies previously implemented, as prescribed in Administrative Case No. 257, for purposes of this case. These procedures require the maintenance of appropriate accounts for non-regulated activities.

The Third Report requires "the transfer of both the deferred tax reserves and unamortized investment tax credits with the associated embedded CPE" in keeping with the intent of Congress for the principles underlying the credit.¹³ In following the requirements, the Commission requires independent telephone companies to follow the guidelines established by the FCC.

Those companies in which the flow-through method of accounting for investment tax credits was chosen are to make adjustments as if the normalized method had been used, thereby permitting the associated unamortized portion to be placed on the deregulated books. The effects of these adjustments are to be borne by the ratepayers since the initial benefit was received by the ratepayers. Estimates are to be made and submitted to the Commission for approval within 30 days of the detariffing date.

¹³ Id., at 21.

Customer Billing and Embedded CPE Tariffs

In response to a request for information in this case dated May 8, 1984, 8 local exchange carriers responded that embedded CPE charges were unbundled on customer bills¹⁴ and 13 responded that embedded CPE charges were bundled.¹⁵

In the opinion of the Commission, as a matter of customer information, detariffing embedded CPE requires unbundling embedded CPE charges -- in other words, embedded CPE charges should be itemized on customer bills separate from all other bill items. At the same time, the Commission is aware that local exchange carriers require lead-time to modify billing systems to separately state embedded CPE charges. Therefore, the Commission will

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- 14 Alltel Kentucky, Inc.
Brandenburg Telephone Company
Continental Telephone Company of Kentucky, Inc.
Harold Telephone Company, Inc.
Highland Telephone Cooperative, Inc.
Logan Telephone Cooperative, Inc.
Salem Telephone Company
South Central Rural Telephone Cooperative Corporation, Inc.

- 15 Ballard Rural Telephone Cooperative Corporation, Inc.
Cincinnati Bell Telephone Company
Duo County Telephone Cooperative Corporation, Inc.
Foothills Rural Telephone Cooperative Corporation, Inc.
General Telephone Company of Kentucky
Leslie County Telephone Company, Inc.
Lewisport Telephone Company, Inc.
Mountain Rural Telephone Cooperative Corporation, Inc.
North Central Telephone Cooperative, Inc.
Peoples Rural Telephone Cooperative Corporation, Inc.
Thacker-Grigsby Telephone Company, Inc.
Uniontown Telephone Company, Inc.
West Kentucky Rural Telephone Cooperative Corporation, Inc.

However, Foothills indicated that it was in the process of unbundling and Cincinnati Bell indicated that it would soon unbundle.

require all local exchange carriers to unbundle embedded CPE charges on customer bills no later than January 1, 1986, which will allow local exchange carriers approximately 4 months from the date of this Order to modify their billing systems as necessary.

In a draft Order dated October 4, 1984, the Commission suggested that embedded multiline intrasystem wire should be considered part of embedded CPE.¹⁶ Local exchange carriers commented both favorably and unfavorably on this proposal.¹⁷

In the opinion of the Commission, requiring embedded multiline intrasystem wire to be considered part of embedded CPE would unnecessarily drive the price of embedded CPE upward and inhibit the sale of embedded CPE. Therefore, the Commission will not require embedded multiline intrasystem wire to be considered a part of embedded CPE for the purpose of embedded CPE sales. However, the Commission will allow the sale of intrasystem wire on a customer-by-customer basis under the same terms and conditions required for the sale of embedded CPE. The Commission will require that local exchange carriers unbundle embedded multiline intrasystem wire charges from embedded CPE or local exchange rates and establish separate embedded multiline intrasystem wire rates, to be filed within 60 days from the date of this Order and to be effective January 1, 1986.

¹⁶ Order dated October 4, 1984, page 7.

¹⁷ See comments on Order dated October 4, 1984.

In a related matter, also in the draft Order of October 4, 1984, the Commission suggested that mixed multiline CPE systems should be detariffed. The Commission is still of this opinion. Therefore, at the option of each local exchange carrier, mixed multiline CPE systems -- that is, systems including both tariffed and detariffed elements -- in service on December 31, 1985, may be detariffed effective January 1, 1986, including intrasystem wire. Multiline systems that become mixed prior to December 31, 1987, may be detariffed upon introduction of detariffed elements, at the option of each local exchange carrier.

As part of its detariffing plan, the Commission will require all local exchange carriers to file marketing plans and tariffs for the sale of embedded CPE no later than 60 days from the date of this Order to be effective January 1, 1986. The tariffs should address such matters as equipment availability (both in-place and from inventory), warranties, credit plans, and prices. Pricing plans may be fixed or variable within a range. Local exchange carriers will not be required to include transaction costs in embedded CPE prices. The Commission will require local exchange carriers to submit a marketing plan describing each carrier's plan for customer notices, advertising and other marketing plans. At a minimum, the Commission will require a bill insert coincident with the unbundling of embedded CPE billing on January 1, 1986, explaining each carrier's embedded CPE sales plan. The Commission is concerned with CPE inventory held by each local exchange carrier and will require the

marketing analyses submitted to specifically address management's inventory reduction plans.

Inventory Differences

A final issue in valuation is the presence within some companies of unaccounted for differences between CPE equipment per books and actual CPE equipment in inventory or in place. Several telephone companies have requested that the cost of this difference be borne by ratepayers. The Commission is of the opinion that the presence of these differences is due to management's failure to perform periodic inventory checks and take effective measures to safeguard these assets. Thus, the Commission finds that it would be unfair to require ratepayers to bear these costs.

SUMMARY

The Commission, after consideration of the evidence of record and being advised, is of the opinion and finds that:

1. Embedded CPE should be detariffed and transferred to a telephone utility's non-regulated activities no later than December 31, 1987.

2. Net book value is the appropriate valuation method in determining the economic value of embedded CPE and its supporting assets.

3. Within 60 days of the date of this Order, all jurisdictional telephone utilities should file plans and tariffs for the sale of embedded CPE effective January 1, 1986.

4. Those jurisdictional telephone utilities not having unbundled billing at the present time are to unbundle embedded

CPE charges on the customer's bill not later than January 1, 1986.

5. The accounting and allocation methodology adopted in Administrative Case No. 257 should be expanded to include embedded CPE.

6. The deferred tax reserves and unamortized investment tax credits should be transferred to the nonregulated activities concurrent with the assets that caused these timing differences.

7. The request of some telephone utilities that rate-payers bear the cost of the differences resulting between CPE per books and actual CPE in inventory or in place due to theft or other losses should be denied.

8. Embedded multiline intrasystem wire should be unbundled from embedded CPE or local exchange rates.

9. Embedded multiline intrasystem wire rates should be filed with the Commission within 60 days from the date of this Order with an effective date of January 1, 1986.

10. Mixed multiline CPE in service on December 31, 1985, may be detariffed January 1, 1986, at the option of each local exchange carrier.

11. Multiline CPE systems that become mixed prior to December 31, 1987, may be detariffed upon the introduction of detariffed components at the option of each local exchange carrier.

12. Each local exchange carrier should file a sale of embedded CPE tariff and marketing plan with the Commission within 60 days from the date of this Order with an effective tariff date

of January 1, 1986, unless the local exchange carrier chooses to detariff embedded CPE on January 1, 1986, in which case it should file its intent to detariff on January 1, 1986, within 60 days from the date of this Order.

IT IS THEREFORE ORDERED that embedded CPE shall be detariffed and transferred to nonregulated activities no later than December 31, 1987.

IT IS FURTHER ORDERED that any telephone utility wishing to detariff its embedded CPE shall notify the Commission at least 30 days in advance of the expected implementation date, but no utility shall detariff prior to January 1, 1986.

IT IS FURTHER ORDERED that net book value shall be used in determining the economic value of embedded CPE and its supporting assets for the purposes of this case.

IT IS FURTHER ORDERED that the generic plan presented by GTKY on behalf of the independent telephone utilities be and is hereby denied.

IT IS FURTHER ORDERED that embedded CPE charges on the customer's bill shall be unbundled by all telephone utilities not later than January 1, 1986.

IT IS FURTHER ORDERED that sales during the detariffing period shall be recorded as prescribed by Part 31 of the FCC Rules and Regulations -- Uniform System of Accounts for Class A and Class B Telephone Companies.

IT IS FURTHER ORDERED that all telephone utilities shall expand their accounting and allocation procedures to include embedded CPE as prescribed pursuant to the Commission's Orders in

Administrative Case No. 257 and other related Orders specifically identified in the final Order in Administrative Case No. 257 dated October 4, 1984.

IT IS FURTHER ORDERED that deferred tax reserves and unamortized investment tax credits associated with embedded CPE shall be transferred to nonregulated activities concurrent with the transfer of assets from the detariffing of CPE.

IT IS FURTHER ORDERED that those companies utilizing the flow-through method of accounting for investment tax credits shall make adjustments as if the normalized method had been used, submitting estimates to the Commission within 30 days of the detariffing date.

IT IS FURTHER ORDERED that the request of some telephone utilities that ratepayers bear the cost of the differences resulting between CPE per books and actual CPE in inventory or in place due to theft or other losses is hereby denied.

IT IS FURTHER ORDERED that embedded multiline intrasystem wire shall be unbundled from embedded CPE in local exchange rates.

IT IS FURTHER ORDERED that embedded multiline intrasystem wire rates shall be filed with the Commission within 60 days from the date of this Order with an effective date of January 1, 1986.

IT IS FURTHER ORDERED that mixed multiline CPE in service on December 31, 1985, may be detariffed January 1, 1986, at the option of each local exchange carrier.

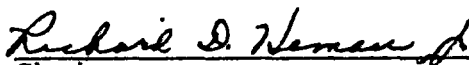
IT IS FURTHER ORDERED that multiline CPE systems that become mixed prior to December 31, 1987, may be detariffed upon

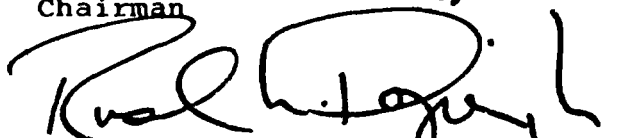
the introduction of detariffed components at the option of each local exchange carrier.

IT IS FURTHER ORDERED that each local exchange carrier shall file a sale of embedded CPE and marketing plan tariff with the Commission within 60 days from the date of this Order with an effective tariff date of January 1, 1986, unless the local exchange carrier chooses to detariff embedded CPE on January 1, 1986, in which case it should file its intent to detariff on January 1, 1986, within 60 days from the date of this Order.

Done at Frankfort, Kentucky, this 10th day of September, 1985.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Secretary